



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Draft

Date Amended:	05/08/07	Bill No:	AB 1206
Tax:	Sales and Use	Author:	Smyth
Related Bills:	AB 1152 (Niello) AB 1681 (Houston) SB 359 (Runner & Dutton)		

BILL SUMMARY

This bill would provide a state sales and use tax exemption (5%) for purchases of machinery, equipment, and replacement parts used directly in research and development (R&D), as specified.

SUMMARY OF AMENDMENTS

The amendments to this bill since the previous analysis address issues raised in the Board's prior analysis related to the confusing language and leased property. Also, the amendments exclude from the proposed exemption, the state General Fund sales and use tax imposed pursuant to Sections 6051.3 and 6201.3.

ANALYSIS

CURRENT LAW

Under current law, entities engaged in activities such as R&D that purchase equipment and other supplies for use in the conduct of their activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. Current law does not provide special tax treatment for purchases of equipment used by entities engaged in such activities.

The statewide sales and use tax rate (7.25%) imposed on taxable sales and purchases of tangible personal property is made up of the following components (additional district taxes are levied among various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	R & T Code
5.0%	State (General Fund)	6051, 6201, 6051.3, 6201.3
0.25%	State (Fiscal Recovery Fund)	6051.5, 6201.5
0.50%	Local Revenue Fund	6051.2, 6201.2
0.50%	Local Public Safety Fund	§35 Art XIII St. Constitution
1.00%	Local (0.25% County transportation funds 0.75% City and county operations)	7203.1

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

PROPOSED LAW

This bill would add Section 6377 to the Sales and Use Tax Law to provide a partial exemption (5%) from the statewide sales and use tax rate operative January 1, 2008 for sales of machinery, equipment, and replacement parts used directly in R&D relating to inventions, products, or technologies.

The bill would define "research and development" by reference to Section 41(d)(1) of the Internal Revenue Code

As a tax levy, the bill would become effective immediately upon enactment.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the California Manufacturers and Technology Association (CMTA). It is intended to end the "double taxation" that R&D equipment is subject to now (taxing the equipment used to produce ideas that, in turn, lead to products that are once again taxed and sold). California's existing 15 percent R&D income tax credit applies only to labor costs and not machinery. CMTA believes the current policy is uncompetitive and needs to be altered to encourage future research in California.
2. **The May 8, 2007 amendments** address issues raised in the Board's previous analysis related to the confusing language and leased property. Also, the amendments exclude from the proposed exemption, the 1/4% sales and use tax imposed pursuant to Sections 6051.3 and 6201.3 (General Fund revenues).
3. **Machinery and equipment should be clearly defined.** In order to avoid any uncertainty in determining the scope of the proposed exemption, it is recommended that the bill incorporate a definition of the machinery and equipment intended to be included. For example, would only those items for which a deduction for depreciation is allowed qualify? Would such items as supplies, hand tools, or data processing equipment qualify? Would component parts of a prototype qualify?
4. **What does "used directly" exactly mean?** To be exempt, the bill requires that the machinery and equipment be "used directly" in R&D. If an item is "used directly" in R&D activities, but only ten percent of the time (it's used for other purposes for the remaining time), would that item qualify? Would a computer system be regarded as "used directly" when used solely by persons conducting the R&D? To avoid uncertainties, and to minimize administrative issues, it is recommended that this be clarified in the bill.
5. **Why not exclude Fiscal Recovery Fund revenues from the proposed exemption?** The bill would exclude from the exemption, a portion of the state's General Fund revenues at the 1/4% rate, yet include within the proposed exemption, those revenues at the 1/4% rate dedicated to the Fiscal Recovery Fund. It is our understanding that this fund is insulated from the state's financial operations, as its use is solely for the benefit of the bonds and its balances cannot be borrowed. To retain a 5% exemption, perhaps the author may wish to eliminate 1/4% the Fiscal Recovery Fund revenues from the proposed exemption, and, instead, include the General Fund revenues imposed pursuant to Sections 6051.3 and 6201.3 at the 1/4% rate.

6. **Related measures.** Other measures that would provide a partial sales and use tax exemption for purchases of items used in R&D and other related activities include:

- AB 1152 (Niello), which is also sponsored by the CMTA, would provide a 5.25% exemption for, among other things, purchases of special purpose buildings and foundations that constitute a research or storage facility used during the manufacturing process by persons engaged in manufacturing and software production, as specified and defined.
- AB 1681 (Houston) would provide a 5.25% exemption for purchases of tangible personal property to be used primarily in, among other things, R&D, as defined, for use by qualified persons engaged in manufacturing, telecommunications, and electrical generation activities.
- SB 359 (Runner and Dutton) would provide a 5.25% exemption for purchases of tangible personal property for use by qualified manufacturers or software producers, as defined, to be used primarily in R&D, and tangible personal property purchased for use by a contractor for subsequent resale to qualified persons for use in the performance of a construction contract of a research or storage facility for use in connection with the manufacturing process.

COST ESTIMATE

The Board would incur costs to administer this measure. These costs would be attributable to, among other things, identifying and notifying qualifying entities, auditing claimed amounts, revising sales tax returns, reviewing returns with claimed exemptions, and programming. An estimate of these costs is pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The NAICS code 5417 is the classification *Scientific Research & Development Services*. According to the Department of Commerce's Economic Census data, machinery and equipment expenditures for businesses coded 5417 is estimated to be \$2.27 billion nationwide. If we assume that California represents 10% of this amount, expenditures by California firms would amount to \$227 million annually.

REVENUE SUMMARY

The annual revenue loss to the state from exempting \$227 million in expenditures by firms with NAICS code 5417, Scientific Research & Development Services, from the state sales and use tax (5%) is estimated to be \$11.3 million.

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Is			1206-2sw.doc

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